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Section 16(b) of the Securities Exchange Act of 1934 provides that certain corporate "insiders" must repay to the corporation any profit they receive as a result of short-swing trading in registered equity securities of that corporation. For a number of years there has been considerable debate over whether such a repayment, when made, is deductible under the federal tax laws. It is the author's thesis that the courts and commentators that have dealt with the question have misconstrued the purpose of section 16(b) and have failed to take into account the economic realities of insider repayments. He contends that section 16(b) is a carefully balanced mechanism to achieve a specific purpose — deterrence of insider trading by non-punitive means. To ensure that the precise policy of 16(b) is not frustrated, the author suggests that the courts analyze the economic effect of a deduction and that in appropriate cases the "frustration of public policy" rationale be used to deny all or a part of an otherwise valid deduction, when to allow such would frustrate the 16(b) policy of non-punitive deterrence.

INTRODUCTION

BECAUSE THE VAST BODY of federal statutory law was, obviously, not enacted as a unified program, often more than one federal statute will have an effect upon a particular area or problem; in these instances of overlapping coverage by two or more federal statutes, it is inevitable that the statutes will at times conflict. Such conflicts may often be reconciled through judicial interpretations. There are, however, instances when nothing short of statutory amendment will suffice to resolve a conflict arising from overlapping legislation.

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One conflict that has plagued the courts for some time arises from the relationship between the repayment of insider profits under section 16(b) of the Securities Exchange Act of 1934 (Exchange Act)[1] and the deduction of such repayments under various provi-

[1] 15 U.S.C. § 78p(b) (1970). Section 16(b) provides, in relevant part:

sions of the Internal Revenue Code. Typically this conflict arises as follows: *X*, a person covered by section 16(a) of the Exchange Act as an insider of ABC Corporation,[2] purchases and sells, or sells and purchases, the common stock of ABC Corporation within a 6 month period, thereby realizing a section 16(b) profit. *X* is then required to repay his profit to ABC Corporation pursuant to section 16(b) of the Exchange Act.[3] Having made the repayment, X claims a deduction on his federal income tax return equal to the amount of the repayment. The Commissioner then disallows the deduction contending that it would weaken the deterrent effect of section 16(b) and thus frustrate the public policy underlying that section. The insider, on the other hand, contends that he is entitled to the deduction as an ordinary and necessary business expense under section 162(a) of the Internal Revenue Code.[4]

It is clear from this example that the aggregate effect upon the insider of the realization and repayment of short-swing insider profits will depend upon the application of provisions of both the Exchange Act and the Internal Revenue Code. It is my contention that the appropriate sections of these statutes can be applied so as

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For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of repurchasing the security sold for a period exceeding six months.

[2] The persons covered under § 16(a) of the Exchange Act are the officers and directors of any issuer which has any equity security registered under § 12 of the Exchange Act or any shareholder who directly or indirectly is the beneficial owner of more than 10 percent of any class of any equity security of the issuer which is registered under § 12 of the Exchange Act. 15 U.S.C. § 78p(a) (1970).

[3] If X's § 16(b) repayment liability stems from his being a beneficial owner of more than 10 percent of a class of equity security as provided in § 16(a), then that liability is restricted to profits from transactions in which *X* was such an owner both at the time of the purchase and the sale. Thus if *X* buys 13 percent of a corporation's outstanding stock on January 1, and then in two completely separate transactions sells 3.1 percent on January 15 and the remaining 9.9 percent on January 16, *X* is only liable for his profits from the January 15 sale. Reliance Electric Co. v. Emerson Electric Co., 404 U.S. 418 (1972).

[4] In the cases decided to date the insider has been an officer or director and has claimed an ordinary and necessary business expense deduction under § 162(a) of the Internal Revenue Code. Section 162(a) provides in relevant part: "There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. . . ." Int. Rev. Code of 1954 § 162(a).

to adequately handle the repayment-deduction issue without distorting either federal statute for the sake of the other.

II. JUDICIAL BACKGROUND

In order to place the repayment-deduction issue in proper perspective, it is necessary to examine the development of the case law to date.[5] The Tax Court's first examination of section 16(b) of the Exchange Act occurred in *William F. Davis, Jr.*[6] Davis, a director of United Drug, Inc., sold 1000 shares of United Drug stock for $25,441.50. Less than six months later he purchased 2,000 shares of United Drug under the terms of an executives' stock option plan. United Drug requested that Davis pay to the corporation $12,659, the difference between the proceeds from the sale and the cost of 1,000 of the 2,000 shares he later purchased.[7] Davis repaid these profits to United Drug and claimed a federal income tax deduction equal to the amount of the repayment.[8]

The Commissioner disallowed the deduction contending that the repayment of insider profits pursuant to section 16(b) of the Exchange Act was in the nature of a penalty. The Tax Court upheld the disallowance of the deduction, stating that the essential question is whether allowance of the deduction would frustrate public policy;[9] the court concluded that the payment of profits was a penalty and that deduction of the payment would frustrate public policy by weakening the deterrent effect of section 16(b).[10]

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[5] In recent years there has been considerable interest in the tax effects of the repayment of insider profits under § 16(b). *See* Darrell, *The Tax Treatment of Payments Under Section 16(b) of the Securities Exchange Act of 1934*, 64 HARV. L. REV. 80 (1950); Lokken, *Tax Significance of Payments in Satisfaction of Liabilities Arising Under Section 16(b) of the Securities Exchange Act* of 1934, 4 GA. L. REV. 298 (1970); *Insider Profit Repayments — Deductibility*, TAX MANAGEMENT MEMORANDUM, No. 71-25, 3 (Dec. 13, 1971); Bureau of National Affairs, *Conflict? Exchange Act, Sec. 16(b) v. Internal Revenue Code, Sec. 162*, SEC. REG. & L. REP. No. 129, B-1 (Dec. 1, 1971); Note, *Tax Treatment of Payments for Apparent Violations of Section 16(b) of the Securities Exchange Act of 1934*, 36 ALBANY L. REV. 736 (1972); Note, *Repayment of Profits Realized in Violation of Section 16(b) of the Securities Exchange Act of 1934 by a Corporate Officer in Order to Protect His Corporate Position and Business Reputation is Deductible by Him as an Ordinary and Necessary Business Expense*, 9 HOUSTON L. REV. 841 (1972).

[6] 17 T.C. 549 (1951).

[7] *Id.* at 554.

[8] Davis based his claim for deduction on §§ 23(a)(1) and 23(e) of the Internal Revenue Code of 1939. Section 23(a)(1), the ordinary and necessary business expense deduction, was the forerunner of § 162(a) of the 1954 Internal Revenue Code; section 23(e), which allowed a deduction for losses incurred by an individual taxpayer, was the predecessor of § 165(c) of the 1954 Internal Revenue Code.

[9] 17 T.C. at 555.

[10] In reaching its conclusion that the section 16(b) payment was a penalty, the Tax

In *Laurence M. Marks*,[11] decided shortly after *Davis*,[12] the Tax Court came to a different conclusion. Marks was a director of Shamrock Oil and Gas Corporation and senior partner of an investment banking firm that had made purchases and sales of Shamrock stock on several occasions within periods of six months. As a partner, Marks' share of the profits from these transactions was $17,672.08, which he later repaid to Shamrock. Marks claimed a deduction for the repayment as either an ordinary and necessary business expense under section 23(a)(1) or as a loss under section 23(3) of the Internal Revenue Code of 1939.[13] Relying on *Davis* the Commissioner disallowed the deduction.

The Tax Court, however, reversed the Commissioner and allowed Marks' deduction. The court was influenced by three factors: the petitioner's unblemished reputation in the investment community;[14]

Court reasoned that the objective of section 16(b) was *punitive* rather than *remedial*. The *Davis* court stated that Davis' payment did not remedy any injury to United Drug or its shareholders and that, in fact, there had been no injury to the corporation or to its shareholders in the first place. The sole purpose of the § 16(b) payment, the court noted, is to deter insiders from unfairly using inside information to reap profits for themselves. Thus, since § 16(b)'s objective is to deter, rather than to rectify, insider abuses, it is punitive in nature. On this basis, the court reasoned that the allowance of a deduction for a § 16(b) payment would weaken the deterrent effect intended by Congress and would, therefore, be against the public policy of curbing insider abuses, the underpinning of § 16(b). *Id.* at 557-58. The Internal Revenue Service agreed with the *Davis* decision when it stated in 1952, that no deduction should be allowed for the repayment of insider profits because the section 16(b) sanction is in the nature of a penalty and allowance of a deduction would, therefore, frustrate public policy. I.T. 4069, 1952-1 CUM. BULL. 28.

11 27 T.C. 464 (1956).

12 In Robert Lehman, 25 T.C. 629 (1955), the first case after *Davis* raising the issue of a deduction for the repayment of insider profits, Lehman, a director of Pan American Airways Corporation, realized short-swing "profits" in a sale-purchase transaction in 1943. Lehman repaid his "profits" to Pan American in 1945 and claimed a deduction. It was disallowed by the Commissioner. In upholding the disallowance, the *Lehman* court stated, without further comment:

> This issue [the deductibility of the repayment of insider profits] was extensively discussed in *William F. Davis, Jr.*, 17 T.C. 549 (1951), and a holding reached adverse to the petitioner. That case is dispositive of this issue and we hold that no deduction is allowable to the petitioner with respect to such repayment. *Id.* at 635.

13 See note 8 *supra*.

14 As the court put it:

> At the time that the matter of the transactions in Shamrock stock was under discussion, petitioner was a vice president of the Investment Bankers Association of America. He was expected to be, and in the following year was, elected president of that organization. He has served as a governor of the New York Stock Exchange, as a governor of the National Association of Securities Dealers, Inc., and on various committees of the New York Stock Exchange, as well as on many charitable boards. He has an excellent reputation in the business and financial fields as an investment banker and director. 27 T.C. at 464.

the subsequent exemption from section 16(b) coverage of some of the transactions which resulted in Marks' liability;[15] and the indirect purchase and sale of the stock in the name of Marks' investment firm rather than directly by Marks himself.[16] The court concluded that the allowance of a deduction in *Marks* would not obstruct the prevention of the unfair use of insider information, the goal of section 16(b). The court distinguished *Davis*, pointing out that in that case "[t]he deduction sought was denied . . . because it was felt that *under the facts there* its allowance would as a matter of fact violate sharply defined public policy. . . ."[17]

The Tax Court followed the position it took in *Marks* in *William L. Mitchell*.[18] Mitchell, an officer of General Motors, sold and then within six months repurchased GM stock at a lower price. Mitchell repaid the resulting section 16(b) profit to the corporation and deducted that amount from his income tax. Although the *Mitchell* facts paralleled those of *Davis* more closely than those of *Marks*,[19] the Tax Court stated that "the case of *Laurence M. Marks* . . . [is] directly in point."[20] The court thus held that the facts and evidence presented by the petitioner established that he was entitled

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[15] In December, 1947, Marks' firm purchased 14,800 shares of Shamrock, part of a public offering, in order to avoid the unfavorable impact that this unsold portion of the public offering might have had upon the then prevailing market price of the Shamrock shares. In subsequent months, the firm sold these shares to the public and participated in a secondary distribution of 163,303 shares of Shamrock stock. These types of transactions were exempted from section 16(b) by rule of the SEC after the *Marks* transaction. Rule 16b-2 exempts certain transactions effected in connection with a distribution of a substantial block of securities if (1) the person engaging in the transaction is doing so in the ordinary course of business; (2) the block of securities is purchased by such person from the issuer or another person with a view to the distribution of the securities; and (3) other persons are engaged in the distribution on terms equal to those afforded such person. 17 C.F.R. § 240.16b-2 (1969). Although it is not clear from the *Marks* opinion, rule 16b-2 appears to be the exemption to which the court referred.

[16] The court found that "[t]here was a serious question as to whether [Marks] was in fact liable under section 16(b) . . . ." 27 T.C. at 467. Although it is not clear from the opinion, the question of Marks' liability seems to have arisen from the fact that Marks did not directly participate in the trading. The court pointed out that Shamrock was advised by its attorney that "no case had determined whether a partnership with a member of the type described in section 16(b), or such partner, was liable thereunder. . . ." *Id.* at 466.

[17] 27 T.C. at 469 (emphasis added).

[18] 52 T.C. 170 (1969), *rev'd*, 428 F.2d 259 (6th Cir. 1970), *cert. denied*, 401 U.S. 909 (1971).

[19] In both *Davis* and *Mitchell*, the insider transaction was a sale followed by a purchase, which produces no realized gain, and therefore in both no tax liability was incurred on the § 16(b) transaction. *Marks*, however, involved several purchase-sale transactions that did produce income tax liability for the insider profits.

[20] 52 T.C. at 173.

to an ordinary and necessary business expense deduction under the rule of law announced in *Marks*.[21]

The court in *Mitchell* rejected a contention by the Commissioner that the petitioner was only entitled to a capital loss, an argument based on the Supreme Court's rationale in *Arrowsmith v. Commissioner*.[22] In *Arrowsmith*, the taxpayer had received distributions from a corporation in connection with a complete liquidation of the corporation, and, in a subsequent tax year, had claimed an ordinary loss for his payment of a judgment rendered on an obligation of the corporation. The United States Supreme Court disallowed the taxpayer's claim for an ordinary loss, reasoning that the nature of the loss must be characterized in the same manner as the earlier distribution since the loss was incurred by the taxpayer solely because he was a recipient of that earlier distribution. Since the distribution had produced *capital* gain, the subsequent loss must be characterized as *capital* loss.

The Tax Court, however, pointed out that Mitchell's loss was not related to his earlier sale but rather was directly related to his purchase of the stock. There were, the court reasoned, two separate transactions. The first transaction, consisting of the purchase and sale of GM stock, had tax significance because it resulted in a capital gain. The second transaction, involving the sale of the stock and then a purchase within six months, produced no taxable gain and thus had only securities law significance. Since the repayment related to the second transaction, the court refused to say that the capital gain character of the profits of the first transaction necessitated capital treatment of the subsequent loss.

The court noted that *Arrowsmith* was inapplicable for another reason: no relationship existed between the amount of capital gain Mitchell realized on his initial sale of GM stock and the amount of his subsequent section 16(b) profit. The independence of these sums is clearly demonstrated by the fact that the measure of the section 16(b) profit inuring to the issuer as a result of the purchase would have remained the same even if the initial sale had actually resulted in a capital loss to Mitchell.[23]

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21 The repayment was found to be an ordinary and necessary business expense deduction because it was an expense incurred for the protection of the taxpayer's business reputation. According to the court, the repayment was made to avoid litigation and the damaging publicity to the taxpayer's business reputation that might accompany it.

22 344 U.S. 6 (1951).

23 *See* 52 T.C. at 174. If *X* Corporation stock with a basis of $20 is sold for $10 ($10 loss), and with six months other *X* Corporation stock is acquired for $5, there is

The Commissioner appealed the decision in *Mitchell* to the United States Court of Appeals for the Sixth Circuit which reversed the Tax Court and held that Mitchell was entitled to only a capital loss rather than an ordinary and necessary business expense deduction.[24] According to the Sixth Circuit the Tax Court was at a disadvantage when it decided *Mitchell* because it did not have the benefit of the United States Supreme Court decision in *United States v. Skelly Oil Co.*[25] The court was "convinced that if the Tax Court had considered *Skelly Oil*, it would have applied the *Arrowsmith* doctrine in *Mitchell* and held that the amount paid by the taxpayer to General Motors must be treated as a capital loss deduction."[26]

In *Skelly Oil*, the corporation was required to repay income which had been taxed after a 27.5 percent oil depletion allowance.[27] Skelly Oil deducted the full amount of the repayment as an ordinary deduction but the Commissioner disallowed it. The Supreme Court held that the corporation had to reduce its deduction by the amount of the depletion allowance in order to offset the tax benefit it had already received as a result of that allowance. In accordance with *Arrowsmith*, the Court reasoned that if money was taxed at a special lower rate when received, the taxpayer would be allowed an unfair tax windfall if repayments were generally deductible at the higher rate applicable to ordinary income.

The Sixth Circuit in *Mitchell* relied upon both *Skelly Oil* and *Arrowsmith*. The court pointed out that Mitchell had been taxed at favorable capital gain rates when he sold his GM stock and that if he were now allowed an ordinary deduction for the insider profits repayment, he would be receiving favorable tax treatment twice.[28]

James E. Anderson[29] was the first case subsequent to the Sixth

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a $5 "profit" that inures to X Corporation. *See* 2 L. LOSS, SECURITIES REGULATION 1062 (2d ed. 1961).

24 Mitchell v. Commissioner, 428 F.2d 259 (6th Cir. 1970), *rev'g* 52 T.C. 170 (1969), *cert. denied*, 401 U.S. 909 (1971).

25 394 U.S. 678 (1969).

26 428 F.2d at 260. The Court of Appeals for the Sixth Circuit explained that the *Skelly Oil* decision had been announced on April 21, 1969, only 9 days before the Tax Court opinion in *Mitchell*. *Id.* at 262.

27 In 1958, Skelly Oil had refunded over $500,000 to two of its customers for overcharges in the six preceding years. The company had been setting its prices during those years on the basis of a minimum price order of the Oklahoma Corporation Commissioner. When the Commissioner's order was vacated, several of Skelly Oil's customers filed claims for the overcharges. The overcharges had been reported as income during this period and, as such, had received the benefit of the oil depletion allowance.

28 428 F.2d at 261.

29 56 T.C. 1370 (1971).

Circuit's decision in *Mitchell* to present the Tax Court with the issue of the tax deductibility of section 16(b) repayments. The factual pattern in *Anderson* was quite similar to *Mitchell*. Anderson, an officer of Zenith Radio Corporation, sold Zenith shares at a substantial profit and reported the profit as a long-term capital gain. Less than six months after the sale, Anderson purchased Zenith shares at a price lower than his earlier sales price. Anderson repaid the section 16(b) profit to Zenith and deducted the amount of the repayment as an ordinary and necessary business expense. Relying upon *Mitchell*, the Commissioner disallowed the deduction and ruled that Anderson was entitled only to a capital loss.

The Tax Court reversed the Commissioner's ruling and held that Anderson was entitled to an ordinary and necessary business expense deduction under section 162(a).[30] The court concluded that *Skelly Oil* and *Arrowsmith* did not apply to the *Anderson* situation:

> We see no need to restate our reasons for holding that *Arrowsmith* does not apply herein. They are fully set forth in our opinion in *Mitchell*. It is sufficient to emphasize that in *Arrowsmith* the payment which the taxpayer was called upon to make arose out of his status as a shareholder of the corporation; he was required to meet an obligation which attached to the assets which he had received in the course of a corporate liquidation. The same analysis disposes of *Skelly Oil*. In that case, the taxpayer was a supplier, which received sums from its customers in an earlier year against which it took a depletion deduction. When it refunded that money in a later year, it was carrying out obligations imposed upon it as that same supplier with respect to those same funds.
>
> In the instant case, the situation is quite different. Here, the sale was made by petitioner in his capacity as a stockholder of Zenith. His obligation to make the payment in question arose out of his status as an employee of Zenith. Neither the sale or purchase nor combination thereof imposed any obligation upon him. Thus, *Arrowsmith* and *Skelly Oil* are both distinguishable because the payment was not directly and integrally related to the earlier sale transaction which gave rise to the capital gain and because the status of petitioner in making the payment differed from that which he had at the time such gain was realized.[31]

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30 The Tax Court found that Anderson was engaged in the business of being a corporate executive and that the § 16(b) repayment was made in connection with this "business." The petitioner proved to the satisfaction of the court that he believed that his employment with Zenith might have been jeopardized if he had refused to make the repayment. The court noted that under his employment agreement with Zenith, he earned $50,000 annually, but that Zenith could terminate his employment at any time. In the event of termination, Anderson would be retained in an "advisory" capacity at an annual compensation of $20,000. *Id.* at 1371-72.

31 *Id.* at 1374-75. It is curious that the Tax Court chose to use status in this case as a determining factor in distinguishing *Arrowsmith* and *Skelly Oil*. If the individual were covered under 16(b) of the Exchange Act by virtue of his being a 10 percent share-

Anderson demonstrates that the Tax Court has chosen to stand staunchly by the position it took in *Mitchell* that an officer is entitled to an ordinary and necessary business expense deduction for the repayment of insider profits. *Anderson* also marks the Tax Court's second rejection of *Arrowsmith* as a basis for analyzing this problem, as well as a rejection of the Sixth Circuit's suggestion that *Skelly Oil*, in conjunction with *Arrowsmith*, dictates that the insider receive only a capital loss for the repayment of his insider profits.

Thus, the current status of the law pertaining to the deductibility of repayments under 16(b) of the Exchange Act may be summarized as follows: First, it is clear that the Tax Court, except in the Sixth Circuit, will allow an insider who is an officer or director to claim an ordinary and necessary business deduction for the repayment of insider profits.[32] Second, the ordinary and necessary business expense deduction will be allowed irrespective of the type of transaction that produced the insider profit.[33] Third, in the Sixth Circuit, the director or officer will be allowed a capital loss rather than ordinary deduction.[34] And finally, the tax treatment of an insider who is a 10 percent shareholder but not an officer or director remains an open question.[35]

III. THE CASE LAW — A CRITICAL VIEW

Initially it should be noted that the only courts that have been confronted with this issue, the Tax Court and the Sixth Circuit Court of Appeals, have come to contradictory conclusions. More importantly, however, neither court has paused to examine the economic aspects of the issue. It is submitted that if such an examination were undertaken, the rationales of both courts would be found untenable.

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holder in the corporation rather than being an officer and director, both the sale that results in the violation and the subsequent repayment of the 16(b) profit will be made in his capacity as a shareholder. Thus, status will no longer be available as a distinguishing factor, unless being an insider by virtue of being a 10 percent shareholder is different than being a shareholder in the ordinary sense. In any event, the two transactions, that is the initial sale and the subsequent repayment following a purchase, are unrelated in the framework of the tax laws and the tax treatment of one should not influence the tax treatment of the other.

32 James E. Anderson, 56 T.C. 1370 (1971); Laurence M. Marks, 27 T.C. 464 (1956).

33 See cases cited in note 32, *supra.*

34 Mitchell v. Commissioner, 428 F.2d 259 (6th Cir. 1970), *rev'g*, 52 T.C. 170 (1969), *cert. denied*, 401 U.S. 909 (1971).

35 None of the decided cases have involved an insider who was a more than 10 percent shareholder. For a detailed discussion of the status of the shareholder-insider, see text accompanying notes 87-100 *infra.*

The Commissioner's and Sixth Circuit Court's view that an insider is entitled to only a capital loss for the repayment of insider profits is unpersuasive. The arguments of the Tax Court in *Mitchell* and *Anderson* militate against the application of *Arrowsmith* or *Skelly Oil* to the insider situation. If the *Arrowsmith* rationale cannot be used to characterize the transactions as capital in nature, then in order to do so one would have to find some support in the Internal Revenue Code itself. Under the provisions of the Code, however, a short-term capital loss is defined as a "loss from the *sale* or exchange of a capital asset held for not more than 6 months. . . .",[36] while a long-term capital loss is defined as a "loss from the *sale* or exchange of a capital asset held for more than 6 months. . . ."[37] In a sale-purchase transaction, the repayment of the insider profit is not related to "a sale or exchange of a capital asset," but rather relates to the *purchase* of a capital asset.[38] Thus, characterizing such repayments as capital losses, as the Commissioner and the Sixth Circuit would do, is without support in either the Code or the related case law.

The Tax Court also, has failed to provide a viable solution to the repayment-deduction problem. First, the court's decisions have not furnished a tenable rationale to support its position that an ordinary and necessary business expense deduction should be allowed for insider repayments, especially in light of the "frustration of public policy" doctrine. In *Marks*, the initial Tax Court case to permit the deduction, the court justified the allowance by the bald conclusion that this would not frustrate the public policy of section 16(b). The court did not, however, define the public policy of section 16(b) or explain why the allowance of the deduction would not frustrate such policy. Moreover, the Tax Court in *Marks* failed to adequately distinguish the *Davis* case. Refusing to explicitly overrule *Davis*, the *Marks* court took the position that *Davis* and *Marks* were distin-

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36 INT. REV. CODE OF 1954, § 1222(2) (emphasis added).

37 *Id.* § 1222(4) (emphasis added).

38 This point raises the theoretical question of whether 16(b), in a sale-purchase transaction, is concerned with the use of inside information at the time of the sale or at the time of the subsequent purchase. It would seem that since the "profit realized" is the difference between the sale price and the price at the subsequent purchase, the statute must operate on the assumption that the inside information would be used at the time of the sale. The statute does not prohibit, however, the sale itself but rather uses the purchase to trigger the violation. Thus, it is reasonable to characterize the repayment as related to the purchase, rather than to the sale of a capital asset. It should be noted that to characterize the repayment as "related to" the purchase of capital assets is not to say that it is a cost of acquisition such as to give rise to a basis adjustment. *See* note 68 *infra* & accompanying text.

guishable "on the facts." This apparent change in position without adequate justification is a fundamental weakness in the Tax Court's handling of the repayment-deduction issue.

In addition, both the Tax Court and the Court of Appeals have failed to examine the actual economic effect of the deduction in the specific factual situations before them.[39] The *Mitchell* insider transaction, if analyzed in this manner, would perhaps have led the Tax Court to a different conclusion than it reached. Mitchell's "profit" of $17,939.29 was a purely paper profit caused by the application of section 16(b) to his sale-purchase transaction. This transaction had no tax significance since there was no realized gain for federal income tax purposes. Nevertheless, Mitchell claimed, and was allowed by the Tax Court, an ordinary and necessary business expense deduction in an amount equal to the amount of the insider "profit" — $17,939.29. Assuming that Mitchell was in a 50 percent tax bracket, the value of this deduction to him would be $8,969.65. Although Mitchell originally repaid this entire profit to the corporation, the net effect to Mitchell of the repayment followed by allowance of an ordinary deduction is to permit him to repay only $8,969.65, one-half of the amount of his insider profit. It is difficult to imagine that such a result would not frustrate the policy underlying section 16(b) of the Exchange Act.[40] Nevertheless, this is exactly what the Tax Court decision in *Mitchell* would have permitted, and the Sixth Circuit by allowing a capital loss reaches the same result, though to a lesser degree.

IV. A SUGGESTED APPROACH

It is possible to approach the repayment-deduction issue in such a way as to avoid the weaknesses of the approach presently employed by the courts. More importantly, the approach I shall suggest is intended to adequately handle all types of insider transactions and to treat all insiders equally, without distorting either the Exchange Act or the Internal Revenue Code for the sake of the other. Essentially, the suggested approach will allow a deduction in those situations where it would further the policy of section 16(b) and to disallow the deduction when it would frustrate that policy.

[39] In *Davis*, for example, the Tax Court stated the general proposition that allowance of a deduction would frustrate the public policy underlying § 16(b), but it did so without examining the actual economic effect of allowing Davis' deduction, and without considering that there might be circumstances where the allowance of the deduction would not frustrate the enforcement of § 16(b).

[40] *Cf.* Tank Truck Rentals, Inc. v. Commissioner, 356 U.S. 30 (1958).

A. *The Policy of Section 16(b)*

The policy underlying section 16(b) should be the deciding factor in determining whether to allow or disallow a deduction for the repayment of insider profits, if such a process can take place without frustrating a provision or policy of the Internal Revenue Code. It is essential, therefore, to examine the policy of section 16(b).

The policy of section 16(b) is clearly set forth in the section itself:

> For the purpose of preventing the unfair use of information which may have been obtained by such [insider] by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer . . . within any period of less than six months . . . shall inure to and be recoverable by the issuer. . . .[41]

It is important to note that section 16(b) requires repayment of merely the "profit realized,"[42] and not of a greater or lesser sum. It is evidently the intent of section 16(b) that the insider simply be deterred from participating in short-swing transactions, rather than punished in the strict sense *because* he traded. But the deterrent may be more than the prospect that the insider's economic position will be reversed with precision; *i.e.*, the "profit realized" referred to in section 16(b) may not be directly proportionate to the economic profit or loss experienced by the "short swinger."[43]

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[41] 15 U.S.C. § 78p(b) (1970).

[42] It should be noted that the "profit realized" in section 16(b) is not necessarily tax, or even economic, realization. In fact an economic loss in a transaction will not exclude a 16(b) profit. *See* notes 49, 50, *infra* & accompanying text.

[43] It can be argued, perhaps, that Congress intended repayment under § 16(b) to operate *in addition to* any tax liability incurred by the insider. Certainly, in the purchase-sale transaction and in at least one sale-purchase, the short sale, Congress knew that the insider would incur a tax liability for the realization of his gain. Therefore, should not the taxpayer be denied a deduction for the repayment of his profit even in the purchase-sale transaction because to allow a deduction would frustrate the policy underlying section 16(b)? Although this argument is not without some basis in fact and logic, it is, nevertheless, not persuasive. As one commentator has urged:

> Absolute prohibition of short-term trading would have operated with undue harshness in many instances. For example, an insider who has purchased may be forced to sell within six months thereafter, by an unexpected personal need for funds. Or an insider may purchase stock to support the market for the company's shares. Such trading would not violate the purposes of [§ 16(b)], if the insider did not benefit unfairly from inside information. Congress apparently recognized justification for short-swing insider trading in some cases and determined that the temptation to profit unfairly by such transactions would be effectively checked by making the trading profitless. It is at least arguable, therefore, that a tax result which effects an ultimate *after-tax cost to the insider in excess of the profit* recoverable by the corporation *would frustrate*, rather than serve, the policy expressed in section 16(b) by upsetting the

While the legislative history of the section is not conclusive, it tends to support this view.[44] The earlier drafts of the bill had an outright prohibition against short-swing trading, but this was considered too severe a penalty, bringing with it, among other things, the criminal sanctions of the Act.[45] It is fairly clear then that the statute was not meant to serve as punishment, at least in the criminal sense. Further, one of the draftsmen indicated that it was the intent to hold the insider liable regardless of his intent to make an unfair profit, but at the same time allow him to engage in short-swing transactions if he found it necessary: "Let him get out what he put in, but give the corporation the profit."[46] It would seem, therefore, that rather careful consideration was given to the method of deterrence adopted in section 16(b), and that it was intended to be exacting, though not penal, in nature.

Some support is also to be found in the case law interpreting section 16(b). In *Adler v. Klawens*[47] the Second Circuit found that for purposes of construction and intrepretation the statute was to be considered remedial:

> The objective was not to punish but to deter the persons in these three categories — directors, officers, 10% beneficial owners — from making improper use of information gained in a representative capacity. The practices could not be prevented *in toto* but Congress sought to take the profit out of what it considered improper conduct. It is plainly a remedial step, as opinions of this court have indicated, even though in certain circumstances the remedy seems harsh.[48]

That the statute can be harsh in wringing the profit out of a transaction is well illustrated by Learned Hand's opinion in another Second Circuit case.[49] In that case the defendant, in a series of transactions covered by 16(b), suffered an economic loss of over $400,000, but incurred a 16(b) liability of $300,000, the amount of

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closely balanced sanction thereby imposed. Lokken, *supra* note 5, at 303 (footnotes omitted, emphasis added).

[44] *See generally*, H.R. REP. NOS. 1383, 1838, 73d Cong., 2d Sess. (1934); SEN. REP. NOS. 792, 1455, 73d Cong., 2d Sess. (1934).

[45] 15 *Hearings Before Senate Comm. on Banking and Currency on S. Res. 84, 56, and* 97, 73d Cong., 2d Sess. 6430 (1934).

[46] *Id.* at 6557.

[47] 267 F.2d 840 (2d Cir. 1959).

[48] *Id.* at 844.

[49] Gratz v. Claughton, 187 F.2d 46 (2d Cir.) *cert. denied*, 341 U.S. 920 (1951). For a further examination of computation of profit see 2 L. LOSS, SECURITIES REGULATION 1062-66 (1961); 5 *id.* at 3024-27 (1969).

his section 16(b) "profit."[50] Thus, though the statute is remedial, it is strict in its remedy.

What is evident from all of this is that the statute is a strange, though carefully planned, instrument for achieving a rather specific goal: the deterrence of short-swing insider trading. As a former chairman of the SEC and one of its Special Counsel wrote:

> We are unaware of any other statute that offers a precise analogy to this subsection. It has within it elements of an ordinary shareholder's derivative suit for damages based upon a breach of fiduciary duty, elements of a statutory action for punitive damages, and elements of an informer's statute . . . . The courts have found each of these analogies useful, but none furnishes compelling authority.[51]

In short, section 16(b) is *sui generis*. It is a carefully balanced mechanism to provide for deterrence and at the same time allow for activity. This balance is achieved by requiring the insider to repay his "profit," but only his "profit," which is the difference between the purchase and sale or sale and purchase price. Further, it should be noted that there are two separate points here: first, while the statute is meant to be a deterrent, it is not meant to absolutely prohibit insider trading activity; and second, the repayment of the profit realized is not meant to reverse the insider's economic position with precision. It is this concept which should be the starting point for examining the repayment-deduction issue.

B. *Analysis of Transactions and Examination of Potential Tax Effects*

The tax effects to the insider of his repayment to the corporation are an integral part of the repayment transaction and must therefore be considered in the calculation of the net amount that the insider actually loses as a result of section 16(b). In some circumstances, allowance of a deduction will result in a net loss of less than the insider profit; in others, disallowance of the deduction will result in loss of more than the insider profit. To ensure that the insider suffers a loss no greater or less than his 16(b) repayment, the economic effects of the allowance or disallowance of a deduction must be analyzed under the particular facts of each insider transaction.

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[50] *See* 2 L. LOSS, *supra* note 49, at 1063-64 & n.118, and text accompanying notes 81-85, *infra.*

[51] Cook & Feldman, *Insider Trading Under the Securities Exchange Act*, 66 HARV. L. REV. 385, 408 (1953).

As a general rule, a deduction should be allowed only to the extent necessary to offset the tax cost of insider profit repayment in order not to disturb the carefully balanced mechanism of 16(b). This principle requires that a policy of automatically allowing a deduction for all insider profit repayments be rejected, as an economic analysis of various possible inside transactions illustrates.

1. *The Purchase-Sale Transaction.*— A purchase-sale transaction involves a purchase followed by a sale within six months. The sale may result in a taxable short-term capital gain.[52] If a director-insider, X, purchases stock in his corporation for $10 and less than six months later sells that stock for $20, he has a short-term capital gain of $10. If X subsequently repays his profit to the corporation and takes no deduction for that repayment, he is losing more than his insider profit; he is losing the tax on that profit as well. Assuming that X is in a 50-percent tax bracket he would pay $5 in income taxes on his $10 short-term capital gain.[53] If he then repays the $10 profit under section 16(b), his total out-of-pocket expense is $15, which is more than the insider profit he is required to pay under section 16(b).

This inequitable result can be rectified if the insider is permitted a deduction producing a tax benefit in an amount equal to the tax cost of the transaction. The allowance of an ordinary deduction equal to the amount of the repayment would result in such a tax benefit, when there is short-term capital gain. Thus, if X is allowed a deduction for the amount of his $10 repayment, he obtains a tax benefit of $5, which exactly offsets the amount of his tax cost and results in a net payment by X of his profit and no more.

It is possible, however, for a purchase-sale transaction to result in long-term capital gain, or even a loss, and at the same time result in 16(b) liability. In determining realized gain for tax purposes,

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[52] As stated in INT. REV. CODE OF 1954, § 1222(1): "The term 'short-term capital gain' means gain from the sale or exchange of a capital asset *held for not more than* 6 months, if and to the extent such gain is taken into account in computing gross income." (emphasis added). In order to be recoverable under § 16(b), the gain must be due to a purchase and sale which occurred in *less than six months*; thus, the gain produced by a purchase-sale transaction which violates § 16(b) will of necessity be short-term capital gain, if the stock sold is the same as that purchased.

[53] The statement in the text assumes that X has no short-term losses, long-term capital gains, or long-term capital losses from securities transactions other than those covered by § 16(b). If the insider does have other long-term gains and/or short-term or long-term losses, the actual tax paid on the insider transaction (if indeed, any tax is incurred) may be more or less than $5. For a more detailed discussion, see note 87 *infra* & accompanying text.

it is necessary to determine basis,[54] which is generally cost.[55] When a shareholder sells a portion of a number of shares acquired at different times and/or prices, he must identify, if possible, the specific stock he is selling in order to determine the basis and holding period of those shares.[56] In determining 16(b) liability, however, no such identification is required or even desirable. If there has been a purchase of stock by an insider, followed by a sale within less than six months at a higher price, then 16(b) liability results regardless of whether the stock sold was identical to that purchased less than six months earlier or stock that had been held for a longer period.[57] Thus, if X buys stock at $50, then one year later buys more stock at $60, and within less than six months sells for $100 the shares bought over a year ago at $50, he will have a long-term capital gain of $50 but a 16(b) liability of $40. To allow in this situation an ordinary deduction for the full amount of the repayment would result in a larger tax benefit than the tax cost to the insider, and would permit the insider to make a net repayment of less than the insider profit. In order to avoid this result a part of the deduction should be disallowed under the frustration of public policy rationale so that the tax benefit exactly equals the tax cost.[58]

If the transaction results in a capital loss to the insider as well as a 16(b) profit, then the result should be quite different. If the insider bought stock at $100, one year later bought stock at $80, then within less than six months sold for $90 the stock purchased at $100, there would be a 16(b) profit of $10 and a capital loss of $10. This, however, should not affect the 16(b) transaction, just as a series of transactions that result in an economic loss does not prevent a 16(b) profit in the same series of transactions.[59] In either case the allowance of a capital loss will not frustrate the purpose of 16(b).[60]

2. *The Sale-Purchase Transaction.*— The sale-purchase transaction presents a very different situation. Here, the insider sells stock in his corporation and within six months repurchases it. No taxable

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54 INT. REV. CODE OF 1954, § 1001.

55 INT. REV. CODE OF 1954, § 1012.

56 *See* Treas. Reg. § 1.1012-1(a), (c) (1957).

57 Smolowe v. Delendo, 136 F.2d 231, 238 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943).

58 *See* notes 74, 75 & accompanying text, *infra.*

59 *See* text accompanying note 50, *supra.*

60 *Cf.* Gratz v. Claughton, 187 F.2d 46 (2d Cir. 1951).

gain is realized.[61] Consequently, since there is no tax cost to the insider as a result of the sale-purchase transaction, it is unnecessary to allow him a tax benefit by way of a deduction for the repayment of his profits. To the contrary, allowance of the deduction in the sale-purchase situation would result in a net payment of less than the total insider profit.[62] Disallowance is therefore necessary to guarantee payment of the full section 16(b) profit, and no lesser amount.

Further inquiry, however, must be made to determine whether disallowance of the deduction in sale-purchase transactions would contravene or distort any provision of the Internal Revenue Code. In general, an insider who has repaid insider profits will be entitled to an ordinary deduction,[63] unless some rationale other than the normal application and interpretation of the appropriate section of the Internal Revenue Code is raised.[64] The "frustration of public policy" rationale,[65] a long-standing doctrine engrafted on the Code by the courts, could provide a basis for denying deductions in sale-purchase transactions. Generally, a deduction will be disallowed if its allowance would frustrate some sharply defined public policy. Typically, the rationale has been invoked to disallow deductions for

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[61] The insider in the sale-purchase transaction *may* have realized a gain on the *sale* of his stock. Any gain so realized, however, is a result of the completed purchase-sale transaction not covered by § 16(b) (*i.e.*, the sale of stock purchased six months or more previously), and is, thus, totally unrelated to the sale-purchase transaction which could result in liability under § 16(b) for the insider.

[62] If our hypothetical director-insider X sold stock for $20 and within six months thereafter purchased an equal number of shares of the stock for $10, he would pay no tax at the time of purchase. Assuming that he is in a 50-percent tax bracket, a deduction in the amount of the repayment, $10, would save him $5, so that the net repayment to the corporation would amount to merely $5 instead of the full profit of $10 required by section 16(b).

[63] To date, the cases considering the repayment-deduction issue have all involved insiders who were officers and/or directors. Although a shareholder-insider might have more difficulty in obtaining a deduction, for the purpose of the discussion at this point, I have assumed that even the shareholder-insider would be entitled to some type of deduction under the Internal Revenue Code. For a more detailed discussion of the shareholder-insider problem, see text accompanying notes 87-100 *infra.*

[64] None of the cases decided to date have disallowed a deduction on the grounds that the insider was not entitled to the deduction within the meaning of the appropriate deduction provision of the Internal Revenue Code. The *Davis* and *Lehman* courts disallowed the deductions claimed on the grounds of frustration of public policy. The Tax Court in *Marks, Mitchell,* and *Anderson* allowed the deductions. The Sixth Circuit, in *Mitchell,* held that a determination of whether the petitioner would *ordinarily* be entitled to a deduction was unncessary because the *Arrowsmith* and *Skelly Oil* decisions precluded allowance of the deduction in any event.

[65] *See generally* J. CHOMMIE, FEDERAL INCOME TAXATION § 42 (1968).

payments that were illegal, such as bribes or "kickback" payments,[66] or that were paid as a result of an illegal activity, such as a fine.[67] Allowance of a deduction in a sale-purchase transaction, as we have seen, permits the insider to retain a part of his profit in the form of a tax benefit. Eliminating the deduction, on the other hand, results in the repayment of the full section 16(b) profit. Therefore, since deductions in sale-purchase transactions frustrate the public policy of section 16(b), they should be disallowed under the frustration of public policy rationale of the Internal Revenue Code.

An argument could be made against this treatment of the sale-purchase situation. In one sense, it could be argued, the insider has more "invested" in the stock that he last purchased than his basis for tax purposes will show. If he had sold stock for $20 and repurchased stock for $10, his basis in the repurchased stock would be $10. As a result of the repayment of the 16(b) profit, however, he will be out not only the $10 that he paid for the stock, but the $10 that he had to repay to the corporation as well, a total of $20. Thus, if he were to sell the stock for $15, he would have to report a $5 capital gain even though he had spent $20 at the time he acquired the stock and suffered a $5 loss as a result of the sale. It would seem, therefore, that the insider should be entitled to something in the nature of a basis adjustment to offset this inequity, similar to that received when brokerage fees are incurred in the purchase of capital assets.[68]

The two situations, however, are not analogous. When brokerage fees are incurred in the purchase of a capital asset, a basis adjustment is allowed because the fee is an integral part of the transaction. In fact, it is likely that the transaction would not take place at all without the services that the fee represents. The expense involved in the repayment of insider profit, however, is not a function of the purchase at all; rather, that expense comes about as a conse-

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[66] *See, e.g.*, Dixie Mach. Welding & Metal Works, Inc. v. United States, 315 F.2d 439 (5th Cir.), *cert. denied*, 373 U.S. 950 (1963).

[67] *See, e.g.*, Tank Truck Rentals, Inc. v. Commissioner, 356 U.S. 30 (1958); Hoover Motor Express Co. v. United States, 356 U.S. 38 (1958). The frustration of public policy doctrine became more securely entrenched in the deduction provisions of the tax law when Congress passed the Tax Reform Act of 1969. In it, Congress enacted much of what had been the judicial gloss of the frustration of public policy doctrine. Congress amended section 162 of the Internal Revenue Code to preclude deductions, in whole or in part, for a payment which was a bribe, fine or penalty, or antitrust damages. Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487.

[68] *See* Treas. Reg. § 1.263(a)-2(e) (1958). While expenses incurred in the acquisition of capital assets are treated as adjustments to basis, expenses incurred in the sale of such assets are an offset against the amount realized. *Id.*

quence of the status of the insider, *i.e.*, that he is an officer, director, or more-than-10-percent shareholder. Without the integral relationship between the expense and the sale, the basis adjustment is not proper, and no such adjustment should be made.[69]

There are two specific types of sale-purchase transactions which deserve comment at this point. These are the "short sale" and the "sale against the box."[70] In the short-sale transaction,[71] the seller sells securities which he does not own at the time of the sale. He must borrow the securities to deliver them to the purchaser and, at some later time, must buy the same securities in the market to "cover," that is, to deliver the securities to the person from whom he borrowed them. Obviously, in such a transaction the short seller hopes to make a profit by selling for a higher price than the price at which he must later purchase to cover. This sale-purchase transaction, unlike the one discussed previously, does produce realized gain which is taxable.[72] Therefore, if the insider engages in a short sale of his corporation's equity securities and the short sale produces realized gain, he should be afforded the same treatment as if the short sale had been a purchase-sale: he should receive a deduction equal to the amount of his repayment of the insider profits.

Just as the short sale is a special type of section 16(b) sale-purchase transaction, the sale against the box is a special version of the short sale. It too is more akin to the purchase-sale than the sale-purchase transaction because it can produce realized taxable gain.[73] In this transaction the seller begins a short sale by selling securities and delivering borrowed securities to the purchaser. However, the seller also owns the same security which he is selling short. If the price rises, instead of buying in the market to cover, the seller simply delivers to the lender the securities which he already owned. If the price falls after the sale, the seller will buy in the market and deliver those securities while he retains the securities he owned at

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[69] *But see*, Lokken, *supra* note 5, at 320.

[70] It should be noted that short sales and sales against the box by directors or officers of the issue, or a beneficial owner of 10 percent of any class of the issuer's securities, are *prohibited* by section 16(c) of the Securities Exchange of 1934. 15 U.S.C. § 78p(c) (1970). This, however, does not change the fact that they may be violations of § 16(b) as well.

[71] The classic definition and description of a short sale is found in Provost v. United States, 269 U.S. 443, 450-53 (1926).

[72] Section 1233(a) of the Code provides that gain or loss from a short sale shall be viewed in the same way as gain or loss from the exchange of a capital asset. INT. REV. CODE OF 1954, § 1233.

[73] INT. REV. CODE OF 1954, § 1233, is applicable, by its own terms, to sales against the box as well as to the normal short sale.

the time of the sale. The sale against the box is thus simply a safer short sale, because the securities which the seller owns at the time of the sale enable him to cut his loss on the short sale if the price of the securities is higher when he must cover.

In any event, the short sale and the sale against the box have the *economic effect* of a purchase-sale transaction even though they are cast in the form of a sale-purchase. Consequently, if an insider engages in a short sale or sale against the box, realizes a profit, pays income tax on his profit and later is required to repay the profit under section 16(b), he should receive the same tax treatment as if he had engaged in a purchase-sale transaction which violated section 16(b).

3. *Repayment in Subsequent Tax Years.*— Another situation which requires careful analysis is the repayment of section 16(b) profits in a tax year subsequent to the year in which the insider realized a short-term capital gain in a purchase-sale transaction. If the insider's tax bracket for the tax year in which the repayment is made is the same as his bracket during the year of the realization of the gain, there is no difficulty in allowing the deduction to the insider, since the tax benefit from the deduction exactly offsets his tax cost.

A more difficult situation arises, however, if the insider is in a different tax bracket in the year of repayment than he was in the year when the short-term capital gain was realized. Suppose that the insider is in a *higher* tax bracket in the year in which the repayment is made. If a deduction of the full amount of the repayment is allowed, the insider will obtain a tax benefit in excess of his tax cost from the short-term capital gain recognized in the prior lower-bracket year.[74] This situation should not, however, render inappropriate the use of the public policy approach. If the entire amount of a deduction can be denied on the grounds that its allowance would violate public policy, then one should certainly be able to deny part of a deduction on the same grounds. Thus, only that part of the deduction which would create tax savings equal to the income tax paid on the short-term capital gain should be allowed.[75]

On the other hand, suppose that the insider is in a *lower* tax bracket in the year of repayment. Even if the taxpayer were allowed a deduction for the full amount of his repayment, his tax savings

[74] If X made a § 16(b) profit of $10 in a year in which he was in a 40-percent tax bracket and repaid the $10 in a subsequent 50-percent tax bracket year, he would have a tax cost of $4 in the first year but receive a tax benefit of $5 in the second year. His net payment would therefore be only $9 instead of the full amount of the $10 profit.

[75] In the example in note 74 *supra* the deduction would be $8.

would be less than the tax paid on the short-term capital gain. This difference would result in an out-of-pocket cost to the insider of an amount in excess of the profit section 16(b) requires him to repay.

To provide the insider in this situation with a tax savings equal to his tax cost it would be necessary to allow him a deduction in excess of the amount of his repayment. But it is questionable whether this can be done under the provisions of the Internal Revenue Code. The frustration of public policy rationale, permitting the disallowance of deductions under certain circumstances, cannot be applied to create a greater deduction than that to which the insider is actually entitled on the basis of his repayment. It is one thing to narrow the scope of the tax law, as when less than the entire amount of the deduction is allowed, but quite another to expand the deduction allowed beyond the express terms of the tax law.

However, the "claim-of-right" doctrine as codified in section 1341 of the Internal Revenue Code[76] may allow for such an expanded deduction. Section 1341(a)(5), if applicable, would permit the insider to subtract from the taxes he is required to pay in a lower bracket repayment year the amount of savings which he would have realized had he taken a deduction for the repayment in the year that he realized the section 16(b) profit. Thus, by employing the claim-of-right doctrine, the insider could enjoy a tax savings upon repayment equal to his tax cost upon receipt of the insider profit, and the policy of section 16(b) would be promoted since the profit, and no greater amount, would be repaid.

Because the policy of 16(b) requires the disallowance of a deduction for repayments pursuant to sale-purchase transactions,[77] the claim of right doctrine need be considered only in the context of the purchase-sale transaction. In order to qualify for treatment under section 1341, an insider who has engaged in a purchase-sale transaction that violates section 16(b) must show that:

> (1) an item was included in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to such item;
>
> (2) a deduction is allowable for the taxable year because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item or to a portion of such item; and
>
> (3) the amount of such deduction exceeds $3000 . . . .[78]

[76] INT. REV. CODE OF 1954, § 1341.

[77] *See* text accompanying notes 61-63 *supra*.

[78] INT. REV. CODE OF 1954, § 1341(a).

The greatest obstacle to the application of section 1341 to 16(b) repayments is posed by Revenue Ruling 68-153.[79] This ruling sets forth the Service's interpretation of the section 1341(a)(1) requirement that the taxpayer appear to have had an unrestricted right to the funds when received. The Service ruled that section 1341 was inapplicable to funds received under a mistake of fact, since a taxpayer does not have an unrestricted right to an item if, on the basis of facts not actually known to the taxpayer but available at the time of receipt of the item, the liability to repay is clear.

Although the typical section 16(b) violation involves funds recovered under a mistake of law, rather than of fact, the former should not justify a different result under Revenue Ruling 68-153; in either event, information establishing the obligation to repay is *available* at the time of receipt of the funds.

It could be argued, however, that Revenue Ruling 68-153 should not be followed, at least as it applies to repayments by insiders under section 16(b). The position of the Service, in light of the language of section 1341(a)(1) which states that there need be a mere "appearance" of an unrestricted right to an item, is unsupported. This language would seem to indicate that Congress intended section 1341 to operate where the taxpayer has a bona fide belief that he has an unrestricted right to funds, even though information to the contrary may be available.

Significantly, section 1341 seems to be the only path available for an insider seeking a deduction in an amount greater than his repayment. As we have seen, the frustration of public policy rationale is inapplicable.[80] Therefore, unless the claim-of-right doctrine can be successfully employed, the deduction taken by an insider who makes his repayment in a lower-bracket tax year must be limited to the amount of the repayment, and that will be less than the tax paid.

4. *Multiple Purchase-Sale Transactions.*— Another problem area involves the multiple purchase-sale transaction which occurs when the insider makes two or more purchases and sales of his corporation's stock within six months. A special rule has evolved for determining the 16(b) profit for such a series of transactions. The case of *Smolowe v. Delendo Corp.*[81] contains the clearest expression of this rule, which has been paraphrased as follows:

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[79] Rev. Rul. 153, 1968-1 CUM. BULL. 371.

[80] *See* text accompanying notes 75, 76 *supra*.

[81] 136 F.2d 231 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943).

> Listed in one column are all the purchases made during the period for which recovery of profits is sought. In another column is [sic] listed all of the sales during that period. Then the shares purchased *at the lowest price* are matched against an equal number of the shares sold *at the highest price* within six months of such purchase, and the profit computed. After that the next lowest price is matched against the next highest price and that profit is computed. Then, the process is repeated until all the shares in the purchase column which may be matched against shares sold for higher prices in the sales column have been matched off. . . . The gross recovery is the sum of the profits thus determined.[82]

To illustrate the *Smolowe* rule, let us suppose that our hypothetical insider made the following purchases and sales, each of the same amount of stock and at the prices indicated below:

Date	*Purchase*	*Sale*
June 1, 1972	$100	$130
July 1, 1972		
July 15, 1972	140	
July 31, 1972		170
August 1, 1972	180	
October 15, 1972		150
Total	$420	$450

In this particular series of transactions, the taxpayer would realize a short-term capital gain of $30, assuming that the stock involved in these transactions is all of the stock owned by the insider. But his section 16(b) "profit" would be $80.[83] Thus, as this example clearly shows, the 16(b) profit may be a different amount than the actual gain realized on a multiple purchase-sale transaction.

As in other transactions the insider should only be allowed to deduct that part of his repayment which produces a tax benefit equal to his tax cost. For example, if the insider in the example above is in a 50-percent tax bracket, he will incur a short-term capital gains tax of $15 on his $30 of realized gain. In addition, the insider can offset a short-term capital loss incurred in the transactions against a short-term capital gain of $30 in the example, thus "losing" the benefit of a $30 setoff upon repayment.[84] Therefore, only $30 of the $80 repayment should be permitted as a deduction.[85] Allowance of

[82] Rubin & Feldman, *Statutory Inhibitions Upon Unfair Use of Corporate Information by Insiders*, 95 U. PA. L. REV. 468, 482-83 (1947) (emphasis added).

[83] The lowest purchase price was $100, and the highest sale was $170, hence a $70 § 16(b) profit. The next lowest purchase price and highest sale price were $140 and $150, respectively, resulting in a $10 § 16(b) profit. Since loss transactions do not affect 16(b) computations, the process stops here with a total 16(b) profit of $80.

[84] The situation is somewhat more complex if the short-term loss is offset against long-term capital gain or ordinary income. *See* pp. 353-54 *infra*.

[85] The multiple purchase-sale problem might be made more complex if the repay-

any greater amount would, in effect, permit the insider to keep a portion of his gain.

5. *Computation of Actual Tax Cost.*— It is essential to compute the tax cost of a section 16(b) repayment correctly, because it is this cost which eventually determines the amount of the deduction which should be permitted. In some cases the actual tax cost will differ from the amount of taxes actually paid. For this reason, even though short-term capital gains are in many instances taxed at the taxpayer's ordinary income tax rate, it is not sufficient in all cases to compute the tax cost by simply multiplying the realized gain by the insider's marginal tax rate. Suppose, for example, that an insider realizes a short-term capital gain of $100 in a transaction which violates section 16(b). If, in the same year, in a transaction not covered by section 16(b), he has a short-term capital loss of $50, the *net* short-term capital gain upon which the insider must pay taxes would be $50. Assuming that the insider has neither long-term capital gains nor long-term capital losses, and assuming also that he is in a 50-percent tax bracket, the tax incurred on his insider profit would be $25. However, the total actual tax cost the insider incurred as a result of the insider trading is more than the $25 tax he is required to pay. In addition to the tax paid, the insider has lost the benefit of his short-term capital loss which might otherwise have shielded other income. Had it not been for the short-term capital gain realized in the insider trade, the insider would have had his $50 short-term loss available to offset his ordinary income, which would have produced a tax savings of $25. Thus the total actual tax cost to the insider in this situation is $50, or the sum of the $25 tax paid and the $25 in tax savings lost. Therefore, if the insider in this case is required to repay his $100 insider profit, he should be allowed the full $100 as a deduction. This deduction, at a tax rate of 50 percent, would produce a tax benefit of $50 to completely offset the $50 actual tax cost.

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ment is made in a tax year subsequent to the year of the gain, and in that subsequent year the taxpayer's tax bracket has changed. If the insider's bracket is *higher* in the year of the repayment even *less* of the repayment should be allowed as a deduction; if his tax bracket has risen to 60 percent, $25 (instead of $30 as in the example in the text) will produce $15 in tax benefits to offset the tax cost. If the insider's bracket has *decreased* to 40 percent, for example, he may receive better treatment in the multiple purchase-sale transaction than in the normal purchase-sale. In the simple purchase-sale, the insider cannot completely offset his tax cost because to do so would require a deduction in an amount *greater* than the actual repayment. In the multiple purchase-sale, however, the insider can offset the tax cost; this is so because in this situation the repayment is greater than the taxable gain. In the example, the insider can completely offset his tax cost by deducting $37.50.

More complex is the situation where there is a long-term capital loss which is set off against a part or all of the short-term capital gain produced in the 16(b) transaction. Here the actual tax cost will depend on how the long-term loss would be used to shield other income had the short-term gain not been made.[86]

It is beyond the scope of this article to examine in detail all of the situations that might arise where special care must be taken to precisely calculate the actual tax cost of an insider profit because the insider has other short-term gains or losses, for long-term gains or loses. It is sufficient to point out that in these situations very careful analysis is required to insure that the amount allowed as a deduction will *exactly* offset the actual tax cost to the insider.

6. *Shareholder-Insider Transactions.*— A shareholder who is not a director or officer of the corporation may nevertheless be deemed an insider under section 16(b) if he owns more than 10 percent of any class of equity security in the corporation.[87] If, however, a shareholder-insider is required to make a section 16(b) repayment, he will not be able to claim an ordinary and necessary business expense deduction under section 162(a) of the Internal Revenue Code since the status of being a shareholder is not a business. Consequently, if a shareholder-insider is to be afforded treatment equal to that afforded director-insiders and officer-insiders under section 162(a), the shareholder-insider must take advantage of some other provision of the Internal Revenue Code. The most appropriate provision is section 212 of the Code, which provides a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income; for the management, conservation, or maintenance of property held for the production of income; or in connection with the determination, collection, or refund of any tax.[88]

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[86] *See generally* INT. REV. CODE OF 1954, §§ 1201, 1202, 1211, 1212, 1222.

[87] 15 U.S.C. § 78p(a) (1970).

[88] INT. REV. CODE OF 1954, § 212. Section 212 was enacted specifically to provide an individual who was *not* engaged in a business, a deduction for ordinary and necessary expenses similar to the business expenses which could be deducted by individuals engaged in a business under § 162(a). In discussing this point, Professor Chommie has stated:

> Although the concept of "trade or business" contained in section 162(a) is broad, embracing both employees and professionals, the Supreme Court in 1941 in Higgins v. Commissioner, [312 U.S. 212 (1941)] restricted its meaning as applied to an investor who maintained an office for handling his security and property investments. A deduction for the expenses of maintaining the office was denied on the grounds the taxpayer was not engaged in a trade or

None of the cases decided to date, however, have involved a shareholder-insider. Therefore, it is unclear whether the shareholder-insider would be entitled to a deduction for the repayment of insider profits even under section 212. Although there is no case authority on the repayment-deduction issue, a case discussing the deductibility of dividends repaid by a shareholder to his corporation may support the allowance of a deduction to the shareholder-insider. In *Estate of Crellin v. Commissioner*,[89] taxpayers had repaid dividends which had been declared and paid to them in the same tax year. The court held that the dividends were includable in the taxpayers' gross incomes, even though the dividends had been repaid in the same tax year in which they had been declared and paid, because the dividends had been repaid voluntarily. However, the *Crellin* court stated in dictum that if dividends were paid in one year and were repaid in a subsequent year under circumstances in which the repayment of dividends could have been compelled, the shareholder would be entitled to a deduction.[90] The *Crellin* dictum could apply specifically to a shareholder-insider who repays his section 16(b) profit. Whether a lawsuit had been initiated prior to the repayment or not, it can certainly be said that the 16(b) repayment could have been compelled. Therefore, by analogy to *Crellin*, the shareholder-insider should be entitled to a section 212 deduction for his repayment of insider profits.[91]

An additional basis for allowing the shareholder-insider a de-

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business within the meaning of section 162(a). The reaction of Congress was the enactment of what is now section 212 of the Code which provides a separate non-business expense category. J. CHOMMIE, *supra* note 65, § 40 at 68.

89 203 F.2d 812 (9th Cir.), *cert. denied*, 346 U.S. 873 (1943).

90 The court stated that:

> The Lesoine case [United States v. Lesoine, 203 F.2d 123 (9th Cir. 1953)] is authority for the proposition that if a dividend is received in a given year under a claim of right and without restriction as to use, but in a subsequent year the invalidity of the dividend is established and its return compelled, the amount so returned is nonetheless taxable in the year received. If the repayment could have been compelled, however, the stockholder is entitled to a deduction in the year of repayment. *Id.* at 814.

91 Although the dictum in *Crellin* concerned the repayment of a dividend in a year *subsequent* to the year in which it was received, the dictum, when applied to the shareholder-insider problem, ought to support the section 212 deduction even where the repayment occurs in the same tax year as the gain was realized as long as the repayment could have been compelled under law. Presumably, the *Crellin* dictum discussed a subsequent repayment because such a repayment would require a deduction to offset the inclusion of the dividend in the taxable income of an earlier year. If the dividend has been repaid in the same year (and its repayment could have been compelled), the dividend would not be includable in the taxpayer's taxable income in the first place, thus obviating the necessity for a deduction.

duction in the purchase-sale transaction is the very purpose of section 16(b).[92] A failure to consider the tax consequences of deduction by the shareholder-insider of his section 16(b) profits may contravene the policy of 16(b) by causing the repayment of either more or less than the amount of "profit" required to be repaid under section 16(b). Moreover, section 16(a), without distinguishing among them, covers officers and directors of any issuer which has any equity security registered under section 12 of the Exchange Act and any shareholder who directly or indirectly is the beneficial owner of more than 10 percent of any class of any equity security registered under section 12. Thus, in light of the policy of section 16(b) and the purpose of section 212 of the Code, it is necessary that all insiders, whether officers, directors, or more-than-10-percent shareholders, be treated similarly under the tax law. The dissent in the *Anderson* case supports the view that all insiders must be given the same tax treatment, although it would differ from my view of what that treatment should be:[93]

> [U]nresolved by the majority opinion is whether different treatment should be accorded directors and shareholders affected by section 16(b). Is a shareholder who, either voluntarily or under some form of compulsion, makes a repayment of his "insider" profit to a corporation entitled only to a capital loss deduction while an officer of the same company is entitled to an ordinary-loss deduction? Is a corporate director who receives minimal directors fees from the corporation entitled to an ordinary-loss deduction under similar circumstances? I think not. It is my view that officers, directors and "10 percent" shareholders should all be treated as investors with respect to trading in the capital stock of their companies. . . . *Any gains or losses from the sale of their stock, as well as profits they might be required to restore to their companies under section 16(b), should be consistently treated. No sound reason for bifurcating these transactions has been advanced in the majority opinion.*[94]

Finally, a shareholder-insider might be eligible for a capital loss deduction under section 165(c)(2) of the Internal Revenue Code, which provides a deduction for losses incurred in any transaction entered into for profit, though not connected with a trade or business.[95] The Third Circuit Court of Appeals in *Weir v. Commis-*

[92] *See* notes 52-60 *supra* & accompanying text.

[93] The dissent would have affirmed the Commissioner's decision that only a capital loss should be allowed for the repayment of insider profits, as opposed to this writer's view that an ordinary loss should be allowed the insider in the purchase-sale transaction and no deduction of any kind should be allowed in the sale-purchase situation.

[94] 56 T. C. at 1378 (dissenting opinion; emphasis added).

[95] INT. REV. CODE OF 1954, § 165(c)(2).

sioner[96] established that the purchase and sale of stock, in most instances, is a "transaction entered into for profit" under section 165 (c)(2): "[T]he intention to purchase stock must from the very nature of the thing purchased include the intention to receive profits (dividends or accretion in value) unless the purchaser knows at the time of purchase that such profits are an impossibility."[97]

Nevertheless, the application of section 165(c)(2) to the shareholder-insider situation is not without problems. Under 165(c)(2), the insider-shareholder must demonstrate that the repayment of 16(b) profit was a loss "incurred in" the purchase and sale of stock. Arguably, the repayment of 16(b) profit by a shareholder-insider is a loss incurred in the purchase and sale of stock for profit because the obligation to make the repayment would not have arisen but for the shareholder-insider's stock trading activities.[98] In addition, as a policy consideration, section 165(c)(2) should be construed to allow the shareholder-insider a deduction in order to provide for the equal treatment of shareholder-insiders and director-insiders or officer-insiders. Such treatment is consonant with the policy underlying section 16(b) of the Exchange Act.

An allowance of a deduction under section 165(c)(2), however, does not completely resolve the shareholder-insider's dilemma. Deductions under section 165 are subject to the limitations imposed under section 1211 of the Code, which provides that "losses from sales or exchanges of capital assets shall be allowed only to the extent of the gains from such sales or exchanges."[99] Stocks are certainly capital assets within the definition of section 1221. Thus, assuming that the shareholder-insider would qualify for a deduction under section 165(c)(2) for the amount of his repayment, he would be limited, nevertheless, to a capital loss deduction. For this reason the deduction under 212 is to be preferred.

In any event, a shareholder-insider who is permitted a deduction under sections 212 or 165 should receive the same treatment as a director-insider or an officer-insider. Of course, the public policy rationale should also be applied to the shareholder-insider. Generally, in the purchase-sale situation, the shareholder-insider should be allowed a deduction which would neutralize the tax cost of the transaction. If the repayment occurs in a subsequent tax year, the amount

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96 109 F.2d 996 (3d Cir.), *cert. denied*, 310 U.S. 637 (1940).

97 *Id.* at 997.

98 *But see* note 68 *supra* & accompanying text.

99 INT. REV. CODE OF 1954, § 1211.

allowed as a deduction should depend upon the insider's tax bracket in that subsequent year. If the insider's tax bracket in the year of the repayment is the same as or lower than it was in the year of the gain, and the gain was short-term, the entire repayment should be allowed as a deduction. If, however, the insider's tax bracket in the year of the repayment is greater than it was in the year of the gain, only that portion of the repayment which would produce a tax benefit equal to the income tax paid on the gain should be allowed.[100]

C. *Some Anticipated Arguments Against the Public Policy Approach*

As noted previously, the public policy approach suggested in this paper is not easily applied to every situation that might arise. Furthermore, there are several objections which might be raised to applying the public policy rationale to the repayment-deduction issue. Three of the major criticisms are discussed in this section.

1. *Revenue Ruling 61-115.*— The first argument against the application of the public policy rationale might be based upon a revenue ruling promulgated in 1961. In Revenue Ruling 61-115,[101] the Service stated that a deduction should not be disallowed for the repayment of insider profits on the grounds that allowance of the deduction would frustrate public policy. According to the Service:

> The purpose of [§ 16(b) of the Exchange Act] is to place the insider in the same position he would have occupied if he had never engaged in the stock dealings. This purpose is not frustrated by the allowance of a tax deduction for amounts paid by reason of section 16(b); but, rather, the allowance of the deduction is consistent with the purpose of the statute in returning the insider to his original position.[102]

It is apparent from the above statement that the Service has analyzed neither section 16(b) nor its own position very closely. The purpose of section 16(b) of the Exchange Act is not "to place the insider in the same position he would occupy if he had never engaged in the stock dealings" which lead to section 16(b) liability. As is stated explicitly in section 16(b), its purpose is to prevent "the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer . . . ."[103] To effectuate this purpose, 16(b) re-

[100] *See* text accompanying notes 74-80 *supra.*

[101] 1961-1 CUM. BULL. 46.

[102] *Id.* at 48.

[103] *See* text accompanying note 41 *supra.*

quires the disgorgement of "any profit realized" in the insider trading. The purpose of 16(b) must be served *irrespective* of whether the repayment of insider profits places the insider in the same position he would have enjoyed had he not engaged in the proscribed insider transaction.[104]

The nonviability of the Service's position in Revenue Ruling 61-115 becomes clear in those situations in which section 16(b) does *not* put the insider in the same position he would have been in had he not engaged in the insider transaction.

The most graphic illustration of this is the situation where after a series of transactions covered by section 16(b) the insider has suffered an economic loss, but which also results in a 16(b) "profit."[105] Here it is clear that the section does not attempt to put the insider in the same position as he would have been had he not engaged in the insider trade.

Secondly, if it were true that section 16(b)'s purpose is to place the insider in the same position after the insider transaction that he would have enjoyed had he not engaged in the insider transaction, different tax treatment would be necessary in the sale-purchase transaction in order to attain this end. The allowance of an ordinary deduction, or a capital loss deduction as proposed by the Service, would not restore the insider-taxpayer to the position he occupied before the insider transaction. For example, if X, in a 50-percent tax bracket, sold stock at $90, repurchased an identical number of shares at $10 and repaid his profit of $80, a deduction of $80 would not restore his pretrade position. In order to restore the insider to his pretrade position, a basis adjustment would be necessary. His basis in the stock he now owns is $10; however, if the intent is to restore him to his pretrade position, then his basis should be adjusted to reflect the $80 repayment, and he should be given a new basis of $90. But, there is nothing in the Internal Revenue Code which allows for such a basis adjustment.[106] Therefore, Revenue Ruling 61-115 not only misunderstands the purpose of section 16(b) but also applies this misunderstanding inconsistently.

2. *The Tax Reform Act of 1969.*— As was mentioned previously, in 1969 Congress amended section 162 of the Internal Revenue Code by enumerating situations in which deductions

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[104] *See* Gratz v. Claughton, 187 F.2d 46 (2d Cir. 1951).

[105] *See* note 49 *supra* & accompanying text.

[106] *See* note 69 *supra* & accompanying text.

should be disallowed because of public policy.[107] This amendment and its legislative history might serve as the basis for a second criticism of the public policy approach. The Tax Reform Act of 1969 enacted into statutory law much of what had previously been judicial gloss surrounding section 162(a). Furthermore, the legislative history of the amendment states that "[p]ublic policy, in other circumstances [that is, other than the provisions specifically enacted through the 1969 Tax Reform Act], *generally* is not sufficiently clearly defined to justify the disallowance of deductions."[108] This quoted portion of the legislative history might imply that the amendment to section 162 of the Internal Revenue Code was a codification of all the recognized public policy grounds for disallowance.

Any argument, however, against the continued vitality of the public policy rationale, beyond that which is codified in the 1969 amendments, can be overcome by the language of the legislative history. The Committee Report stated that "generally" public policy in areas other than those covered by the 1969 amendments is not clear enough to sustain the disallowance of deductions. However, the policy underlying section 16(b) ought to be one of the exceptions to that general rule. The insider abuses which precipitated the enactment of section 16(b) are well known.[109] If ever there was legislation which epitomizes a specific, clear, and well-defined public policy, it is section 16(b) of the Exchange Act.

3. *The Public Policy Rationale Has Been Rejected by the Courts.* — One final major argument which might be marshalled against the public policy approach is that it has already been rejected by the courts which have considered the repayment-deduction issue. Those advancing this criticism would point out that the *Marks* decision held that the allowance of a deduction to an insider is not against public policy. Furthermore, critics would emphasize that the public policy argument has not even been discussed in the repayment-deduction cases subsequent to the *Marks* decision. Although these statements are true, it is arguable whether they support the notion that the courts have rejected the public policy rationale. It would be more accurate to say that after *Davis* the courts have simply *ignored* public policy.

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107 *See* note 67 *supra.*

108 SENATE COMM. ON FINANCE, TAX REFORM ACT OF 1969, S. REP. NO. 552, 91st Cong., 1st Sess. 274 (1969) (emphasis added).

109 SENATE COMM. ON BANKING AND CURRENCY, STOCK EXCHANGE PRACTICES, S. REP. NO. 1455, 73d Cong., 2d Sess. 55 (1934).

The Tax Court's unexplained distinguishing of the facts in *Marks* from those of *Davis* can hardly be termed a rejection of the *Davis* public policy argument. The cases subsequent to *Marks* did not even consider the public policy argument, let alone reject it. It is, therefore, difficult to glean from any of the cases following *Davis* a clear rejection of the public policy argument.

V. Conclusion

As should be evident from the foregoing discussion, the repayment-deduction issue does not lend itself to simple analysis. This result stems largely from the overlap of the Exchange Act of 1934 and the Internal Revenue Code. Although, at first glance, these two federal statutes seem to be in conflict, the issue can be resolved without rendering one statute subservient to the other. In order to do so, however, the courts must turn to a rationale which they have ignored in recent years. This rationale, the frustration of public policy, which has been a long-standing judicial gloss on the deduction provisions of the Internal Revenue Code, can adequately handle the various circumstances in which the repayment-deduction issue is raised. It should be noted that it is only because of an ambiguity in the Code that the public policy approach can be used to coordinate these two statutes. If the Code were absolute in its mandate, then the coordination would not be possible. The public policy approach provides enough flexibility to cover both the purchase-sale and sale-purchase transactions; furthermore, the public policy rationale can be applied to the shareholder-insider as well as to director-insiders and officer-insiders. It is this versatility which commends the public policy rationale as an appropriate vehicle to resolve the repayment-deduction issue.

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